BEFORE THE
PUBLIC UTILITIES COMMISSION
OF THE
STATE OF CALIFORNIA

In the Matter of the Application of Southern California Gas Company (U 904 G), San Diego Gas & Electric Company (U 902 M) and Southern California Edison Company (U 338 E) for Approval of Changes to Natural Gas Operations and Service Offerings	A.06-08-026

REPLY BRIEF OF CORAL ENERGY RESOURCES, L.P.

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To: The Honorable Thomas R. Pulsifer,
Presiding Administrative Law Judge:

In accordance with Rule 13.11 of the Commission's Rules of Practice and Procedure, Coral Energy Resources, L.P. ("Coral") files its reply brief in the above-referenced proceeding. Coral's reply brief responds to the opening brief submitted by Southern California Gas Company and San Diego Gas & Electric Company ("SoCalGas/SDG&E"), as well as the opening brief of Southern California Edison Company ("Edison").

The utilities bear the burden to prove that the proposed structural changes in the settlement agreement will mitigate SoCalGas' ability and incentive to exercise market power in southern California. The utilities failed, in their opening briefs, to meet their burden of proof. The utilities failed to demonstrate that the thirty-four proposed structural changes, when viewed individually or collectively, will place reasonable limits on SoCalGas' current ability to leverage core assets for the benefit of its shareholders.

The Commission cannot approve the settlement agreement in its entirety. The Commission must reject or modify those structural proposals that increase the optionality of the core procurement department or otherwise maintain or expand SoCalGas' market power in southern California.

I.

INTRODUCTION

Edison's opening brief highlights the potential that exists under current rules for the exercise of market power by SoCalGas' core procurement department.[1] In spite of the market power concerns expressed by Edison, the evidence confirms that a number of the structural proposals in the settlement agreement would maintain or extend, rather than limit, SoCalGas' market power.

Specifically, the proposed combination of SoCalGas and SDG&E's core procurement departments would expand the breadth of SoCalGas' purchasing power and increase the core assets over which SoCalGas exercises control. The utilities' proposed monthly minimum storage injection targets would provide the core procurement department with virtually unlimited storage flexibility. The proposed core balancing rules, as well, would increase the core procurement department's gas purchase flexibility by allocating additional storage to the core. Even the

[1] Edison states that "SoCalGas has a monopoly over gas storage facilities in southern California." Brief at p. 5. Edison emphasizes that SoCalGas has both the ability and the incentive to affect border prices through the core procurement department's control of intrastate transmission, storage, and interstate transportation capacity. Id. at p. 2. Edison states further that SoCalGas has the ability and the incentive to conduct its operations in ways that benefit its shareholders at the expense of other market participants, including gas and electric consumers. Id.

proposed transfer of the Hub services function from the core procurement department to the System Operator would do nothing to limit the core procurement department's ability to affect the timing and the quantity of gas flows into the SoCalGas system.

Furthermore, notwithstanding Edison's claim that SoCalGas' GCIM provides "perverse incentives" for the core procurement department to raise prices and increase volatility in California's gas markets, the settlement agreement proposes no change to the structure of the GCIM. Amazingly, the proposed settlement does not even impose any new limits on the ability of SoCalGas' shareholders to benefit from SoCalGas' exercise of market power. Finally, notwithstanding Edison's claim that a "key principle" of the settlement agreement is "the increase in market transparency and information disclosure" (Brief at p. 8), the proposed settlement fails to require the core procurement department to post any operational information on SoCalGas' electronic bulletin board.

Edison states that the proposed settlement agreement is a "step in the right direction" in resolving Edison's expressed concerns about the exercise of market power by SoCalGas. See Brief at p. 6. This statement, which is repeated throughout Edison's opening brief, is hardly a ringing endorsement of the settlement agreement. In fact, Edison's statement stands in stark contrast to Edison's direct testimony, in which Edison witness Stephen Pickett claimed that the settlement agreement provides "meaningful relief" regarding Edison's concerns. Ex. 47 at p. 7. The Commission should be very concerned about a settlement agreement containing thirty-four structural changes that fails to address the serious market power concerns that have been identified in this proceeding.[2]

[2] Edison states that the settlement has "achieved a series of market reforms that will lead to a more transparent and competitive natural gas market in southern California." Brief at p. 3. Edison's statement may reflect Edison's desire to seek closure to its seemingly endless litigation

SoCalGas/SDG&E's opening brief is equally ineffective in providing evidentiary support for the structural proposals in the settlement. SoCalGas/SDG&E devote most of their brief to attacking the positions of other interested parties. For example, SoCalGas/SDG&E criticize Coral for raising market power concerns in this proceeding,[3] notwithstanding SoCalGas/SDG&E's own counsel's acknowledgment that SoCalGas does indeed have market power with respect to storage and intrastate transmission in southern California. See Ex. 5 at p. 10. SoCalGas/SDG&E's expressed concern about how market power issues were raised in this proceeding masks the very critical issue of whether individual structural proposals will mitigate SoCalGas' market power in any meaningful way.

The evidence demonstrated that most, if not all of the proposals in the settlement agreement reflect SoCalGas' longstanding "wish list" for changes to the structure of its system. See Tr. 3/313-362 (Morrow).[4] The settlement agreement enhances the opportunity for SoCalGas and SDG&E's shareholders to earn profits through unbundled storage, Hub services, and interruptible access charges, as well as through the gas cost incentive mechanism ("GCIM"). SoCalGas/SDG&E argue in their opening brief that the utilities have "presented a very carefully balanced package of changes." Brief at p. 7. The proposals are only "balanced," however, in the

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efforts in I.02-11-040, in which Edison expended approximately $5 million in outside legal fees and expert witness fees. See Tr. 6/848 (Pickett).

[3] SoCalGas and SDG&E assert Coral should have raised its market power concerns in I.02-11-040 or the Continental Forge litigation. Brief at p. 12. Neither D.06-12-034 (in I.02-11-040) nor the Continental Forge settlement limited the issues that may be raised in this proceeding, however, or the parties that may raise them.

[4] SoCalGas/SDG&E policy witness Richard Morrow acknowledged that many of the structural changes in the proposed settlement agreement "made sense for our company and were part of the bargain in exchange for the moneys that were paid out by Sempra Energy to settle the lawsuit." Tr. 3/340 (Morrow).

sense that the proposals, in combination, provide the core procurement department with more assets, greater flexibility, and less scrutiny than exists today.

Edison witness Pickett testified that the purpose of the settlement agreement was to "achiev[e] market reforms that would address the components of the existing southern California gas market that . . . [have] the greatest potential for misuse of market power." Ex. 47 at pp. 5-6. Mr. Pickett identified the "areas of principal concern" as SoCalGas' control over all of the gas storage facilities in southern California, the existing structure of SoCalGas' GCIM, and the excessive integration of SoCalGas' core procurement and operations functions. Id. at p. 6.

Mr. Pickett testified to his view that the structural proposals in the settlement agreement "provide meaningful relief in each of the areas of principal concern identified by [Edison]." Id. at p. 7. When viewed together, however, the structural proposals in the settlement increase SoCalGas' market power, enrich the utilities' shareholders, impose meaningless restrictions on core storage activities, expand the size and profitability of SoCalGas' Hub services, and provide the core procurement department with additional flexibility. Moreover, the settlement adversely impacts customers through: (a) the exclusion of winter hedge transactions from the GCIM; and (b) the sharing of interruptible access charge revenues, Hub service revenues, and unbundled storage revenues between ratepayers and shareholders. Finally, the proposed settlement agreement reduces shareholder exposure (and increases ratepayer exposure) through the exclusion of hedge transactions from the GCIM.

Modifications must be made to individual structural proposals in the settlement agreement in order to ensure that the settlement is in the best interests of SoCalGas and SDG&E's end-use customers. The Commission should also adopt several new structural proposals, including Coral's proposed Core Portfolio Diversity Program, all of which are intended to mitigate SoCalGas' market power.

II.

SUMMARY OF ARGUMENT

The Commission must address either the size of the core portfolio or the activities of the core procurement department if it is to make inroads on the core procurement department's ability and incentive to exercise market power. There are two alternative approaches that the Commission may pursue in this proceeding in order to mitigate SoCalGas' market power. Both of these approaches require changes to the structural proposals in the settlement agreement.

First, Coral's preferred approach is for the Commission to direct SoCalGas to allocate responsibility for the core gas purchase function among five creditworthy wholesale suppliers through Coral's proposed Core Portfolio Diversity Program. The Core Portfolio Diversity Program will ensure that no single entity controls sufficient core assets to exercise market power in southern California. The Core Portfolio Diversity Program will provide a platform for competition among suppliers, which in turn will ensure that core procurement customers receive the benefit of the value of their reserved core assets. If the Commission is not prepared to fully implement Coral's proposal at this time, the Commission can adopt the Core Portfolio Diversity Program on a "pilot" basis in order to provide for a transition to full implementation within a reasonable timeframe.

Second, if the Commission decides to allow SoCalGas/SDG&E to remain as the monopsony purchaser of gas for all of southern California's core procurement load, the Commission must impose stricter limits on the core procurement department's use of reserved core assets. The limitations proposed in the settlement agreement do not impose meaningful constraints on the core procurement department. Changes must be made to several of the utilities' structural proposals in order to place reasonable restrictions on the core procurement department's ability to control gas deliveries into the SoCalGas system and influence border prices.

Specifically, the Commission should adopt stricter monthly storage inventory targets, modify the utilities' core balancing proposal, provide greater transparency through the posting of daily core operational information, modify the GCIM benchmarks, and impose stricter limits on shareholder earnings under the GCIM.[5] These proposed limits are intended to ensure that most of the value of the reserved core assets will be retained by core procurement customers rather than distributed to SoCalGas and SDG&E's shareholders.

Whichever of these two "core procurement" approaches is adopted, the Commission also must modify the GCIM in order to encourage a portfolio approach that includes a balance of index-priced purchases and hedged transactions. Whether gas purchases for the core portfolio are to be made exclusively by the utility or by five wholesale suppliers, the purchaser(s) should have an incentive to pursue low prices, supply reliability, and price stability. A modified gas purchase incentive structure should be adopted.

The Commission also must reject two of the utilities' proposals respecting the unbundled storage program. As the monopoly provider of storage in southern California, SoCalGas should

[5] SoCalGas/SDG&E assert that it is "unreasonable and unfair" for Coral to make recommendations on these structural issues after the end of the hearing. See Brief at pp. 8-9. SoCalGas/SDG&E argue that Coral's comments "should be given no weight by the Commission." Id. at pp. 9, 20, 29. Cross-examination testimony by SoCalGas/SDG&E's witnesses clearly demonstrated, however, that many of SoCalGas/SDG&E's proposals are seriously flawed. Based upon this evidence, interested parties must be permitted to seek modification to the utilities' structural proposals. In this connection, it should be noted that at least two of the utilities' own structural proposals were only revealed to the parties through cross-examination. See Tr. 7/1113-14 (Austria) (balancing); Tr. 4/500-01 (Schwecke) (receipt point access charges for the System Operator).

not be allowed to charge "market-based" prices for unbundled storage. Whatever price is charged by SoCalGas for unbundled storage, however, all of the revenues in excess of cost should be returned to the utilities' ratepayers.

Finally, the Commission must define the responsibilities of the System Operator in order to ensure that the System Operator cannot exercise its market power in a manner that disadvantages other market participants. The System Operator will have inherent advantages in the marketplace due to its unique access to operating conditions and shipper information. The System Operator's activities must be transparent to the market and the System Operator must be subject to the same rules and charges as all other market participants when it engages in the purchase and sale of gas, storage, transportation, receipt point access rights and Hub services. The System Operator must perform all of its functions for the benefit of end-use customers. All revenues received by the System Operator (above cost) should be returned to ratepayers.

III.

ARGUMENT

A. The Utilities' Structural Proposals Do Not Mitigate SoCalGas' Market Power.

Notwithstanding evidence presented by Edison, statements by the Commission in previous decisions, and even statements by SoCalGas/SDG&E's own attorney, SoCalGas/SDG&E continue to insist that SoCalGas does not have market power in southern California. See Brief at pp. 12-13. SoCalGas/SDG&E refer to the market power concerns expressed by Edison and others as a "non-existent problem." Brief at p. 60.

The evidence clearly reflects, however, that SoCalGas has the ability to leverage the assets paid for by others (and upon which it is paid a healthy rate of return) for the benefit of its shareholders. For many of these assets (i.e. storage and intrastate transmission), SoCalGas has a monopoly and has the ability to exercise market power. See Ex. 47 (Pickett) at p. 6. In addition, SoCalGas has unparalleled access to information regarding the market activities of all other market participants on its system. Id. As such, SoCalGas holds a tremendous competitive advantage over any other entity that ships gas on its system.

In short, SoCalGas is unlike any other market participant due to its ability to optimize the assets it controls (but does not pay for), based in part upon the market information to which SoCalGas (and no other entity) has access. SoCalGas' downside exposure is negligible while it has the ability to influence the profitability of its upside potential through the exercise of its market power. These factors are major concerns for market participants.

It is clear by the terms of the settlement agreement that Edison failed to obtain concessions from SoCalGas/SDG&E that would restrict the flexibility currently enjoyed by the core procurement department. The Commission must impose reasonable limitations on SoCalGas' ability to leverage core assets if this proceeding is to have any positive impact on customers and the market.

SoCalGas/SDG&E assert that the Commission "should firmly reject the principle that the core should not have flexibility or optionality in how it uses storage." Brief at p. 9. Coral does not propose that the Commission eliminate the flexibility of the core procurement department to manage core assets. Rather, if the Commission allows SoCalGas to continue to purchase all of the gas for its core procurement customers, Coral seeks to place reasonable limits on the core procurement department so that SoCalGas cannot unduly restrict the availability of capacity or influence prices in southern California.[6]

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[6] Edison policy witness Stephen Pickett explained that SoCalGas currently controls the timing and the quantity of gas flows, which in turn can affect the level of the California border price. See Tr. 6/813-14. Mr. Pickett testified that the core procurement department's "ability to change the operation or actual flows to correspond with the time that will influence border prices gives SoCalGas the ability to potentially affect prices at the California border." Tr. 6/839-40.

Coral also seeks to ensure that the utilities' core procurement customers, rather than SoCalGas and SDG&E's shareholders, reap most of the benefit of the value of the reserved core assets. The evidence illustrated that excessive flexibility and optionality provide SoCalGas' core procurement department with the ability to use core assets in a manner that greatly benefits SoCalGas' shareholders.[7]

The Commission must modify several of the proposed structural changes in the settlement agreement in order to limit the core procurement department's ability and incentive to influence prices in southern California. Changes must be made to the utilities' proposed monthly minimum storage targets, the proposed core balancing rules, and the GCIM. The Commission also must address the market power issues that arise specifically due to the size of the core portfolio.

1. Consolidation of the Two Utilities' Core Portfolios Should be Rejected

SoCalGas/SDG&E assert, in their opening brief, that core portfolio consolidation would "provide significant cost savings to core customers of both utilities." Brief at p. 11. The only cost savings identified by the utilities, however, is an overhead cost savings of approximately $2 million per year. Id.

In D.02-08-065 (August 22, 2002), the Commission dismissed the potential for overhead cost reductions as providing a legitimate basis for core portfolio consolidation. The Commission stated that the savings would be "negligible" when considered in the context of the utilities' overall portfolios. Decision at p. 15. The Commission also noted that the overhead cost savings

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[7] DRA's witness appears to believe that as long as Sempra's shareholder earnings are "capped" under the GCIM, SoCalGas' exercise of market power should not be a concern to core customers or the Commission. See Tr. 8/1310-11 (Ramchandani). All customers, including core customers, are disadvantaged when the market is unduly influenced by external forces. A cap on shareholder earnings under the GCIM is not enough to prevent SoCalGas from exercising market power in southern California.

opportunity would "not offset the potential downsides . . . to consolidating two of the largest supply and capacity portfolios in the State." Id. at p. 10.

The concerns expressed by the Commission in D.02-08-065 with respect to core portfolio consolidation are no less relevant today. As Coral explained in its opening brief, consolidation of the two utilities' core portfolios would increase the potential for SoCalGas' exercise of market power because it would increase the assets over which the core procurement department has control.[8] As a consequence, the Commission should not approve consolidation of the two utilities' core portfolios unless the core gas purchase function is partitioned and core procurement responsibility is allocated among five creditworthy wholesale suppliers.

2. Coral's Proposed Core Portfolio Diversity Program Is Fully Supported by the Evidence.

SoCalGas/SDG&E dismiss Coral's proposed Core Portfolio Diversity Program based upon the utilities' belief that the exercise of market power by the core procurement department is a "non-existent problem." Brief at p. 60. SoCalGas/SDG&E also assert that Coral's proposal would constitute a "radical restructur[ing of] the core gas supply function . . . ." Id.[9]

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[8] A combination of the two utilities' core portfolios would result in a single core procurement entity that holds firm interstate capacity rights of approximately 1.135 Bcf/day, as well as more than 50 percent of SoCalGas' storage inventory capacity (70 Bcf), close to 40 percent of SoCalGas' firm injection capacity (327 MMcf/day), and 70 percent of SoCalGas' firm withdrawal capacity (2,225 MMcf/day). Tr. 5/656, 686, 688 (Goldstein). Under DRA's proposed approach, the combined core procurement department would hold at least 83 Bcf of storage inventory, 368 MMcf/day of firm storage injection rights, and 2,225 MMcf/day of firm storage withdrawal rights. See Ex. 71 (Sabino) at p. 5-6.

[9] SoCalGas/SDG&E liken Coral's proposed Core Portfolio Diversity Program to the core aggregation program. Brief at p. 60. Core aggregation is a retail sales program, however. See Ex. 59 (Dyer) at p. 8. The Core Portfolio Diversity Program is a wholesale supply program under which SoCalGas/SDG&E's core procurement department will continue to make sales of gas to all core procurement customers. Id. Core procurement customers will not experience any change in the reliability of gas supply service or the identity of their retail supplier under the Core Portfolio Diversity Program. Moreover, SoCalGas/SDG&E's reference to the "Georgia"

SoCalGas/SDG&E attack the Core Portfolio Diversity Program based upon their mischaracterization of key elements of Coral's proposal. SoCalGas/SDG&E's criticisms are addressed in turn, as follows:

a. **The Core Portfolio Diversity Program Will Result in Lower Core Procurement Costs**

SoCalGas/SDG&E state that Coral failed to demonstrate that the Core Portfolio Diversity Program will lead to relatively lower procurement costs for SoCalGas and SDG&E's core procurement customers. Brief at p. 60. SoCalGas/SDG&E have ignored the evidence. Coral witness Laird Dyer testified that under the Core Portfolio Diversity Program, bids by prospective wholesale suppliers to participate in the program will reflect a one to three percent decrement (discount) to the "price reference point." Tr. 7/1014.[10] This "discount" will not be shared between ratepayers and the supplier's shareholders, as is the case under the GCIM structure. See Ex. 35 (Goldstein) at p. 4. Rather, 100 percent of the discount will be enjoyed by core procurement customers. See Tr. 7/1011, 1015 (Dyer).

Mr. Dyer explained that wholesale suppliers will offer a discount to the price reference point in order to reflect the value of core asset optimization. Whereas SoCalGas' shareholders retain a substantial percentage of the value of core assets today through the operation of the GCIM, competition among suppliers to provide wholesale gas sales service under the Core

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program (Brief at pp. 60-61) is not applicable because the Georgia program is a retail core sales program. Tr. 7/1017 (Leslie).

[10] Mr. Dyer testified that bids will reflect a one to three percent "decrement" to the price reference point based upon his examination of the results of SoCalGas' operations under its GCIM over the past twelve years. Tr. 7/1014 (Dyer). As a result, marketers will compete with one another to provide this gas purchase service for core customers and they will reflect in their bids the value of core asset optimization. Mr. Dyer testified that prospective WCPAs will "offer a price that reflects value back to the core customers for what they are bringing to the table: . . . a broad array of assets. . . . That is valuable to the marketplace." Tr. 7/1030 (Dyer).

Portfolio Diversity Program will ensure that core procurement customers enjoy most of the value of these core assets. Tr. 7/1014-15, 1030 (Dyer). Contrary to SoCalGas/SDG&E's argument, therefore, Coral's proposed approach will produce substantial cost savings for core procurement customers.

b. An "Exit Strategy" Is Not Required For the Core Portfolio Diversity Program

SoCalGas/SDG&E express concern that Coral has not provided an "exit strategy" in the event the Core Portfolio Diversity Program "fails." Brief at p. 60. SoCalGas/SDG&E seem unable to grasp the concept that the Core Portfolio Diversity Program is a wholesale supply program. The program can only "fail" if all suppliers (hundreds of them) refuse to sell gas to the southern California market. Mr. Dyer testified that the only practical way that any wholesale supply program can fail is if all pipelines serving southern California are out-of service. See Tr. 7/1019 (Dyer).

In order to eliminate any unnecessary concerns regarding supply reliability under the wholesale supply program, however, Coral proposes that each WCPA must provide "backstop" procurement service in the unlikely event that one or more WCPAs defaults on its gas supply obligations. Ex. 59 (Dyer) at p. 17. The Commission-approved contract between each WCPA and SoCalGas/SDG&E's core procurement department will establish the terms and conditions under which a WCPA must deliver its gas to the core procurement department, including consequences for nonperformance. Ex. 59 at p. 17; Tr. 7/1021 (Dyer).[11]

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[11] If the Commission has concerns about the operation of the Core Portfolio Diversity Program, the Commission can adopt Coral's proposal as a "pilot" program. See Tr. 7/1012-13 (Dyer).

c. **<u>The Core Portfolio Diversity Program Will Promote Diversity, Competition and Innovation Among Gas Suppliers</u>**

SoCalGas/SDG&E assert that the Core Portfolio Diversity Program will not increase the "diversity" of core gas suppliers. Brief at p. 61. To the contrary, increased diversity is the bedrock of Coral's proposal. Market power concerns will be eliminated by allocating SoCalGas' current core procurement function (as well as the accompanying core assets) to five wholesale suppliers. Contrary to SoCalGas/SDG&E's argument, WCPAs will purchase gas from a multitude of upstream gas suppliers: as many, if not more suppliers than currently sell to SoCalGas.

Currently, southern California core procurement customers obtain their gas from one supplier: either SDG&E or SoCalGas. Under Coral's proposed Core Portfolio Diversity Program, core customers will be supplied by five wholesale suppliers that will compete not only against a benchmark, but against each other.

d. **<u>Each WCPA Will be Bound by the Terms of a Commission-Approved Contract; SoCalGas Will Not be a "Regulator"</u>**

SoCalGas/SDG&E argue that the Core Portfolio Diversity Program will place SoCalGas in the role of the "regulator." Brief at p. 61. This is not so. Each WCPA will have a contractual agreement with SoCalGas/SDG&E's core procurement department. The terms of the contract will be approved by the Commission. Ex. 59 (Dyer) at p. 17. If a WCPA fails to meet its performance obligations, the WCPA will be in breach of its contract. SoCalGas/SDG&E will address any breach of a WCPA's contract in the same manner that it addresses a breach of a wholesale supplier's contract today.

B. <u>The Gas Purchase Incentive Mechanism Must be Modified to Encourage a Portfolio Gas Purchase Approach</u>

Whether responsibility for core gas purchases is allocated among competing wholesale suppliers or remains with SoCalGas/SDG&E, the procurement incentive mechanism must be modified to encourage a portfolio approach that includes hedged transactions as well as index-priced purchases. Winter hedging should not be addressed outside the incentive mechanism. The purchaser of gas for core procurement customers should be accountable for the cost of all hedged transactions, and should be rewarded if the prices under its hedged transactions are below a properly established benchmark price.

SoCalGas/SDG&E object to Coral's proposed treatment of hedged transactions. SoCalGas/SDG&E assert that Coral's proposal is "biased against customers' interests." Brief at p. 63. The utilities complain because, under Coral's proposal, suppliers will not be penalized for fixed price gas purchases that <u>exceed</u> the benchmark, yet they will be rewarded for fixed price purchases that are <u>below</u> the benchmark. <u>Id</u>.

The evidence demonstrated that Coral's proposed hedging approach will both encourage suppliers to enter into hedged transactions and hold suppliers accountable for prudent hedging practices. Under the current GCIM structure, SoCalGas has been discouraged from entering into hedged transactions because of perceived risks to its shareholders. <u>See</u> Tr. 1/72, 79 (Van Lierop). SoCalGas/SDG&E even acknowledged, in their opening brief, that they "currently do not have plans to engage in long-term fixed price purchases." Brief at p. 63.

SoCalGas/SDG&E state that "the much higher levels of gas costs and increased price volatility have increased the costs of hedging to such a level that continued inclusion of the cost and benefits of Winter Hedges would constitute a strong disincentive on the part of the utilities to hedge winter gas costs at an appropriate level." Notwithstanding the utilities' claim, and regardless of market conditions, SoCalGas/SDG&E have largely avoided hedging activities throughout the life of the GCIM (and SDG&E's Gas PBR) due to the potential negative impacts on their shareholders. Brief at p. 26.[12] The GCIM must be modified, therefore, in order to provide a balanced incentive that encourages prudent hedging activities and index-priced purchases.

Mr. Dyer testified that "[i]n order to motivate suppliers to target low prices, . . . the [gas purchase incentive] mechanism must allow a supplier to share in the cost savings when a fixed priced supply is less costly than the benchmark. . . ." Ex. 59 at p. 15. Mr. Dyer continued: "By holding a supplier harmless for fixed prices that exceed the benchmark, but rewarding the supplier for beating the benchmark, core customers' interests will be aligned with suppliers' interests." Id. Mr. Dyer stated further: "The Commission must provide suppliers with incentives that encourage them to leverage their assets, experience and skills. This is the balance that Coral's proposed Core Portfolio Diversity Program intends to achieve." Id.

Coral submits that if SoCalGas/SDG&E are allowed to continue to purchase all of the gas for core procurement customers, all hedged transactions should be included within the GCIM. Including all hedged transactions within the GCIM will make the utilities accountable for prudent hedging decisions while providing the utilities with an incentive to establish a portfolio that provides price stability at the lowest possible price.[13]

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[12] Edison states that "the gas incentive mechanism was not designed to accommodate hedging activities in a changing market." Brief at p. 19.

[13] Edison states that removal of winter hedging activities from the GCIM "will eliminate potential incentives to manipulate the market prices to make the hedges 'profitable.'" Brief at pp. 7-8. Yet SoCalGas/SDG&E state in their opening brief that under the terms of the settlement agreement, the core procurement department would continue to have authority to engage in hedging within the GCIM during non-winter months. Brief at p. 17. If, as Edison's witness asserted, the GCIM provides SoCalGas with incentives to manipulate market prices (see Tr.

C. **<u>The Utilities' Proposed Annual Procurement Planning Process Would Not Provide Stakeholders With a Meaningful Opportunity for Review.</u>**

The utilities' proposal for an annual core procurement plan and a winter hedging plan should be rejected. In their opening brief, SoCalGas/SDG&E assert that "[t]his new annual procurement planning process . . . will give interested stakeholders a greater voice in how we approach procurement for our customers." Brief at pp. 16-17. This statement is misleading and is not supported by the evidence. Under the utilities' proposal, the annual procurement plan would be filed on a confidential basis. <u>See</u> Ex. 35 (Goldstein) at p. 9. Accordingly, most stakeholders would not have any meaningful opportunity to review or respond to the annual plan.

Moreover, review of the utilities' annual procurement plan by a Gas Procurement Review Group ("PRG") that is comprised exclusively of non-market participants would not provide useful or informed oversight of the utilities' procurement strategy. SoCalGas/SDG&E assert that DRA and TURN have "substantial experience reviewing and making recommendations with respect to . . . retail core natural gas procurement activities, including hedging. . . ." Brief at p. 18. There is a great difference between "reviewing" a procurement plan, however, and demonstrating experience by participating in the hedge market.

The proposed members of the Gas PRG are, at best, spectators regarding risk management. DRA and TURN are ill-suited to the task of overseeing SoCalGas' hedge activities. It takes more than watching golf on television to become a good golfer. Reviewing the utilities' procurement and hedging activities does not make DRA and TURN adroit in the hedge market. Representatives of DRA and TURN acknowledged that they have never participated in the purchase or sale of natural gas, and they have never participated in the market

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6/869-70 (Pickett)), the removal of winter hedges from the GCIM will not eliminate Edison's concerns regarding the incentives embedded in the GCIM.

for hedged transactions. See Tr. 4/493-94 (Florio, TURN); Tr. 8/1299-1300 (Sabino, DRA). Non-market participants are not qualified to provide oversight of the utilities' hedge plans.

SoCalGas/SDG&E assert that their proposal to account for winter hedges outside the GCIM "will benefit customers by ensuring that 100 [percent] of hedge benefits in high-price winters are used to reduce core customers' high winter bills, and by [removing] a disincentive that the utilities would otherwise have to hedge, which will result in a more appropriate level of hedging." Brief at p. 28. The evidence revealed, however, that the proposal to treat winter hedges outside the GCIM would not benefit customers because the proposal does not make the utilities accountable for prudent hedge practices.

In D.06-08-027 (August 24, 2006), the Commission authorized SoCalGas to spend up to $77 million on hedges for the winter of 2006-2007. See Decision at p. 25. Had SoCalGas expended the full amount on core hedges, all of these costs would have been borne by core procurement customers outside the GCIM. If core procurement customers are forced to bear all of the utilities' winter hedging costs, year after year, the utilities will have no incentive to engage in prudent hedge purchases.[14]

[14] If SoCalGas and SDG&E are permitted to file an annual core procurement plan and/or to account for winter hedge transactions outside the GCIM, the utilities' annual procurement plan, as well as the winter hedge plan, should be made publicly available. In view of the size of the core portfolio and the extent of the core procurement function, all market participants, as well as non-market participants, should have the opportunity to review and comment on the utilities' procurement plans. SoCalGas/SDG&E insist that the utilities' annual procurement plans, as well as their winter hedge plans, should be maintained on a confidential basis. Brief at p. 18. Coral disagrees. SoCalGas enters into hedged transactions with multiple counterparties. The counterparties with which SoCalGas engages in hedged transactions are intimately familiar with the terms of the hedge transactions. If these transactions are maintained on a confidential basis, SoCalGas will have the exclusive ability to determine which market participants have access to confidential hedge strategies. This provides an opportunity for SoCalGas to discriminate between and among suppliers.

D. Specific Structural Proposals in the Settlement Agreement Must be Rejected or Modified in Order to Mitigate the Core Procurement Department's Market Power

Several of the structural proposals in the settlement agreement present the potential for extension of the core procurement department's market power. The utilities' proposals for monthly minimum storage injection targets and core balancing, in particular, would provide SoCalGas' core procurement department with additional assets and additional flexibility with which to influence prices in the market. The utilities' proposals must be modified in order to mitigate the potential for these structural changes to increase SoCalGas' market power.

1. Changes Must be Made to the Utilities' Proposed Monthly Minimum Storage Injection Targets

SoCalGas/SDG&E assert that the utilities' proposed minimum monthly storage injection targets "respond to concerns that too much flexibility with storage injections may give [the core procurement department] the ability under certain circumstances to unduly impact gas prices at the California border . . . ." Brief at p. 8. SoCalGas/SDG&E assert that this structural proposal, if adopted, will provide market participants with a "clearer understanding about how the utilities will manage inventory levels for core customers during the storage injection season." Id.

SoCalGas/SDG&E are correct in stating that excessive storage injection flexibility enables the core procurement department to "unduly impact gas prices . . . ." SoCalGas/SDG&E are wrong, however, in suggesting that the utilities' proposed minimum storage injection targets would impose meaningful limits on the core procurement department's flexibility. Contrary to the utilities' argument, the proposed minimum storage injection targets would provide no real limits at all.

Because the minimum monthly storage inventory targets assume an unrealistic storage inventory of zero as of the first day of the storage injection season (April 1), the utilities' proposal does not impose any meaningful minimum storage injection obligation until July. See

Ex. 2 (Van Lierop) at p. 4; Tr. 1/50 (Van Lierop). In reality, the utilities' proposed minimum storage inventory target of 29.9 Bcf for the end of July is 19 Bcf less than the end-of-July storage inventory target that the utilities previously negotiated with DRA and TURN for 2006. Ex. 2 at p. 2; see also Ex. 38.

The utilities' minimum storage injection proposal, if adopted, could force the core procurement department to use "as-available" injection capacity to move gas into storage during the peak months for electric generation load. Tr. 5/ 694-95 (Goldstein). This, in turn, could limit other market participants' access to receipt point capacity and storage injection capacity during the summer peak period. Id.

SoCalGas/SDG&E should be required to establish their minimum monthly injection targets based upon the actual core storage inventory level as of April 1. See Coral Opening Brief at p. 38. The Commission should also establish maximum monthly injection limits that are consistent with the core's firm storage injection capacity. Id. at pp. 38-39.

More specific monthly storage inventory targets will ensure that SoCalGas and SDG&E are able to use firm storage injection rights (not "as-available" storage injections) to move gas into storage for core procurement customers. Because the core procurement department will be able to rely exclusively upon firm storage injections, the core procurement department will be less likely to interfere with noncore customer (including electric generation customer) deliveries to the SoCalGas system during the summer months. Tr. 5/694-95 (Goldstein).

In an apparent attempt to assuage concerns regarding the inadequacy of their proposal for monthly minimum storage injection targets, SoCalGas/SDG&E state that the utilities' annual gas plans "could, on a confidential basis, provide . . . additional guidance with respect to storage injections, including additional targets." Brief at p. 10. This statement undeniably acknowledges the inadequacy of the utilities' core storage injection proposal.

More importantly, the utilities' proposal to consider storage injection targets under the cloak of confidentiality highlights the lack of transparency in the utilities' proposal for an annual gas procurement plan – transparency that SoCalGas/SDG&E policy witness Richard Morrow testified was a key component of the settlement agreement. Tr. 3/338. Monthly core storage injection targets should not be negotiated on a confidential basis between the utility and a few non-market participants. The Commission should establish, in this proceeding, a core storage injection protocol that provides meaningful monthly inventory targets.

2. If the Core Procurement Department is to be Subject to Monthly Balancing, Additional Storage Must be Allocated to the Balancing Function

SoCalGas/SDG&E state that the utilities' proposal to apply the same balancing rules to core customers and to noncore customers is "based on the general principle that the core should operate like the noncore as much as possible." Brief at p. 29. Coral supports application of the noncore balancing rules to the core. The Commission must ensure, however, that if the noncore balancing rules are applied to the core procurement department, the core procurement department will not gain a further competitive advantage by gaining control of additional storage assets.

SoCalGas/SDG&E witness Dr. Johannes Van Lierop acknowledged that the utilities' proposed core balancing rules would increase the flexibility that is currently enjoyed by the core procurement department. Tr. 1/41. The proposed core balancing rules, if adopted, would provide the core procurement department with an additional 10 percent monthly imbalance tolerance, which equates to as much as 300 MMcf/day of additional storage injection and withdrawal capability. See Tr. 5/699 (Goldstein); Ex. 39.

Extending the noncore balancing rules to the core procurement department would shift storage assets that are assigned to the balancing function to the core, thus straining the limited storage assets that currently are allocated to the noncore balancing function. See Tr. 5/699 (Goldstein). It is possible, indeed likely, that application of the balancing rules to core customers could increase the instances of operational flow orders ("OFOs") for all customers. See Indicated Producers Brief at pp. 34-35. Additional storage should be allocated to the balancing function so that core customers can be added to the noncore balancing rules without increasing the risk of OFOs.[15]

3. Balancing Service Should be Provided to all Core and Noncore Customers by the Same Entity

The utilities failed to indicate, anywhere in their prepared testimony, their intent to provide balancing service to core customers and to noncore customers through different entities. Only through the cross-examination of SoCalGas/SDG&E witness Reginald Austria did SoCalGas/SDG&E reveal that the utilities intend for the core procurement department to provide balancing service to noncore customers, while the System Operator provides balancing service to core customers. See Tr. 7/1113-14 (Austria).

If the core procurement department is permitted to provide balancing service for noncore customers, the core procurement department will control all of the storage assets that are allocated to the balancing function. The settlement agreement does not provide that an additional 5.3 Bcf of inventory, 250 MMcf/day of firm withdrawal rights, and 355 MMcf/day of

[15] Alternatively, Coral supports the Indicated Producers' proposal to delay implementation of the core balancing proposal until after a Commission decision in the upcoming BCAP proceeding, at which time the Commission can assess how much additional storage must be added to the balancing function to accommodate core balancing. See Indicated Producers Brief at pp. 28-29. The Commission cannot implement new core balancing rules without addressing storage issues as well.

firm injection rights will be allocated to the core procurement department. If the core procurement department performs balancing on behalf of the noncore, however, these storage assets will effectively be in the control of the core procurement department.

As long as the core procurement department provides balancing services to the noncore, the core procurement department will continue to bear responsibility for "system reliability." This is inconsistent with one of the fundamental objectives of the settlement agreement: separating the core procurement department from the operator of the system. See Ex. 47 (Pickett) at p. 8. The balancing function for core customers and noncore customers should be performed by the same entity. The utilities' proposal to provide balancing through two different entities should be rejected.

4. Modifications to the GCIM Benchmarks are Necessary in Order to Reduce SoCalGas' Ability and Incentive to Exercise Market Power

If the Sempra utilities continue to purchase gas for the entire core portfolio, certain changes should be made to the GCIM in order to ensure that most of the value of the core's reserved assets is retained by core procurement customers. The benchmark prices under the GCIM should be "exogenous": the weighting of index prices should reflect the core procurement department's proportionate capacity holdings in the supply basins in which it holds firm interstate capacity rights. See Coral Brief at pp. 31-32. In addition, the benchmark prices should reflect an equal weighting of first-of-the-month ("FOM") prices and daily prices. Id. at pp. 30-31. Finally, the tolerance bands in the GCIM should be tightened. Id. at pp. 32-33.

SoCalGas/SDG&E oppose modification of the GCIM benchmarks to reflect an equal weighting of FOM and daily indices. SoCalGas/SDG&E state that "Coral's proposal to base GCIM benchmarks on an average of monthly and daily indices would encourage SoCalGas and

SDG&E to include more daily (vs. monthly) purchases in its portfolio of purchases." Brief at p. 63.

It is not Coral's intention to encourage the core portfolio supplier to purchase relatively more gas in the daily market than in the FOM market. Rather, this proposal is intended to provide an accurate reflection of SoCalGas' purchases so that the benchmark is a true indication of SoCalGas' balance of core gas purchases between monthly and daily purchases. Use of SoCalGas' historical purchases as the basis for the benchmark will more accurately reflect the utility's relative purchases of daily and monthly gas supplies. See Tr. 7/1051-52 (Dyer).

E. The Daily Posting of Core Operational Information is Necessary In Order to Address Market Power Concerns With Respect to the Core Procurement Department.

Under the terms of the settlement proposal, the utilities will post, on the electronic bulletin board ("EBB"), weekly information on core storage inventory and the status of the core procurement department's Hub transactions. See Ex. 29 (Schwecke) at p. 17. The settlement agreement does not provide for the posting of daily core storage information, however, and the settlement agreement does not provide for the posting of any core operational information. Coral proposes that core storage information, core Hub information, and core operational information be posted on a daily basis. Ex. 59 (Dyer) at pp. 27-28.

SoCalGas/SDG&E state that "[t]here is no legitimate reason to require the [core procurement department] to share additional, detailed transactional information with its competitors." Brief at p. 37. SoCalGas/SDG&E's expressed concern directly contradicts, however, Edison's statement that "a key principle to the Agreement is the increase in market transparency and information disclosure." Brief at p. 8.

In view of the size of the core portfolio and the extent of the core procurement department's control over reserved core assets, it is appropriate to require the core procurement department to post daily operational information to the EBB. The posting of daily core purchase volumes, core storage injections/withdrawals, and core usage will provide transparency that allows the Commission – and the market – to assess whether the core procurement department is improperly using core assets to limit noncore deliveries or influence prices. Edison's expressed concern regarding the core procurement department's exercise of market power warrants additional scrutiny of the core procurement department through daily operational postings.

SoCalGas/SDG&E state that daily posting of the core procurement department's operational information "would put core customers at a significant disadvantage relative to all other market participants . . . . " Brief at p. 37. The utilities claim that daily core storage postings would enable other market participants to "front run" the core procurement department's gas purchase activities. Id.

SoCalGas/SDG&E's argument respecting "front-running" is a red herring. SoCalGas/ SDG&E assume that other market participants would be able to gain an advantage by using core volume forecasts in order to purchase gas for the purpose of re-selling the gas to the core procurement department at a higher price. Because the southern California border market is a liquid trading point for multiple gas supply sources, however, and because the core procurement department purchases gas at prices linked to index prices, front-running is not an issue. Gas purchases that are tied to index prices will not be affected by disclosure of the core procurement department's daily volume information.

SoCalGas/SDG&E refer to Coral as a "competitor" in the southern California gas market. See Brief at p. 37. SoCalGas is not just another market participant, however. SoCalGas' core procurement load is 46 percent of the total demand on its system. Ex. 59 (Dyer) at pp. 5-6. SoCalGas controls a substantial portion of the firm interstate capacity that serves the southern

California market, and SoCalGas controls a majority of the storage in southern California. SoCalGas' core customers bear the cost of this pipeline and storage capacity, yet SoCalGas has the ability to leverage these core assets for the benefit of its shareholders.

By contrast, SoCalGas' "competitors" - - marketers and suppliers such as Coral - - bear 100 percent of the cost of any storage capacity or pipeline capacity that they obtain in order to serve their own customers. SoCalGas' "competitors" bear 100 percent of the cost associated with risk management, marketing and trading, including 100 percent of the risk of hedge transactions.

SoCalGas is not a competitor on equal footing with other marketers and suppliers. SoCalGas' downside risk is negligible, yet its upside potential is considerable, in view of the size of the core portfolio and the control SoCalGas exercises over core assets. Because SoCalGas possesses market power in southern California, and because concerns have been raised in this proceeding and previous proceedings about the potential for the improper exercise of market power by SoCalGas, it is appropriate and necessary to subject SoCalGas' core procurement department to higher levels of scrutiny than other market participants. See Tr. 7/1032 (Dyer); Ex. 59 (Dyer) at pp. 27-28. The posting of daily core operational information will not impose an undue burden on SoCalGas/SDG&E, and it will not disadvantage the utilities in the marketplace. The utilities should be ordered to provide this information.

F. The Commission Should Adopt Changes to the Utilities' Proposals for Unbundled Storage.

In its opening brief, Coral explained the evidentiary basis for two proposed modifications to SoCalGas' unbundled storage program. First, as the monopoly provider of storage, SoCalGas should be limited to charging cost-based rates for unbundled storage. Second, regardless of the price charged by SoCalGas for unbundled storage, all unbundled storage revenues (in excess of costs) should be returned to SoCalGas and SDG&E's ratepayers. See Coral Brief at pp. 43-46.

1. **Unbundled Storage Should be Priced on a Cost-of-Service Basis**

SoCalGas/SDG&E make a series of arguments in opposition to cost-based rates for unbundled storage. First, SoCalGas/SDG&E state that "[c]ost-based rates would force arbitrary allocation procedures." Brief at pp. 41-42. Coral agrees that if customer and shipper interest in unbundled storage exceeds the availability of unbundled storage capacity, an allocation procedure will be necessary. However, an allocation procedure does not have to be "arbitrary." An allocation procedure can be devised to ensure that all potential storage customers are treated equally. The Commission approved an allocation mechanism for firm access rights in D.06-12-031 (December 14, 2006). An allocation mechanism can be developed for unbundled storage in this proceeding, as well.[16]

Second, SoCalGas/SDG&E argue that "[c]ost based rates would . . . undermine customer-tailored storage services." Brief at pp. 41-42. There is no evidence in the record indicating that SoCalGas would be unable to sell customer-tailored storage services at cost-based rates. In fact, cost-based rates will ensure against undue discrimination by SoCalGas in the marketing and sale of customer-tailored storage products.

Third, SoCalGas/SDG&E state that "[c]ost based rates and termination of the existing 50/50 risk sharing mechanism would ensure that no third-party storage is ever built in Southern California." Brief at p. 42. This argument contradicts reality. SoCalGas was first permitted to

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[16] Coral agrees with SoCalGas/SDG&E on one matter with respect to unbundled storage. SoCalGas/SDG&E state that SCGC's "two-step open season process is . . . an arbitrary proration policy that does not make sense." Brief at p. 41. Coral submits that an allocation process can be developed that is both straightforward and nondiscriminatory. SCGC's proposed allocation approach does not meet either qualification.

charge market prices for unbundled storage under a 50/50 risk sharing mechanism in 2000. Since that time, no third-party storage has been built in southern California. The Commission should not allow SoCalGas to continue to charge market-based prices for unbundled storage simply to try to stimulate interest in third party storage construction.

Fourth, SoCalGas argues that "Coral's storage proposals . . . would . . . diminish the likelihood of storage expansion by SoCalGas." Brief at pp. 42-43. This argument contradicts specific provisions of the settlement agreement. The settlement agreement requires SoCalGas to pursue the expansion of storage without regard to the price charged by SoCalGas for unbundled storage. See Ex. 19 (Morrow), Ex. B, No. 14, pp. B-3-4; Ex. 8 (Watson) at pp. 5-6. Moreover, if the cost of new storage is rolled-in to the cost of service for existing storage, the Commission can direct SoCalGas to construct additional storage at no risk to SoCalGas or its shareholders.

Finally, SoCalGas/SDG&E assert that cost-based rates for unbundled storage "would deny customers $20 million or more in benefits each year." Brief at p. 40. This argument is specious. According to the utilities' own math, if cost-based rates had been in effect for unbundled storage in 2006, SoCalGas' customers would have paid $37.3 million less than they actually paid under market-based prices.[17] Perhaps what SoCalGas/SDG&E meant to report was that if cost-based rates had been in effect for storage in 2006, SoCalGas' shareholders would have been denied $18.6 million in monopoly rents.[18]

A cost-based pricing approach for unbundled storage is intended to impose the actual cost of storage on any customer that buys storage. Core customers pay a cost-of-service rate for "bundled" storage. See Tr. 2/217-18 (Watson); Ex. 25 (Yap, SCGC) at p. 3. No legitimate

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[17] See SoCalGas/SDG&E Brief at p. 40 ($72.2 million less $34.9 million).

[18] Id. ($37.3 million times .5).

reason exists to impose a higher price for unbundled storage on noncore customers or other market participants.

The settlement agreement calls for cost-based rates for transmission and distribution, with balancing account treatment for the transmission and distribution revenue requirement. See Ex. 19 (Morrow) at p. 2; Tr. 3/422 (Morrow). Cost-based rates were approved in D.06-12-031 for firm access rights and unbundled backbone transmission, as well. See Decision at p. 88. As the monopoly supplier of storage in southern California, SoCalGas should be limited to charging cost-based rates for unbundled storage.[19] Balancing account treatment should be afforded SoCalGas' unbundled storage revenue requirement, as well.

2. 100 Percent of Unbundled Storage Revenues (Above Cost) Should be Allocated to Utility Ratepayers

SoCalGas/SDG&E support their proposal for a 50/50 sharing of unbundled storage revenues by stating that the 50 percent shareholder incentive will encourage SoCalGas to expand its storage facilities. Brief at p. 43. The utilities also state that "50/50 risk sharing remains the most appropriate approach to ensure aggressive and innovative marketing of unbundled storage. . . ." Id. at p. 44.

As noted above, SoCalGas does not require an incentive to expand its storage facilities. The settlement provides a mechanism for identifying the need for expanded storage facilities. The settlement also provides a cost recovery structure for storage expansion projects. See Ex. 19 (Morrow), Ex. B, No. 14, pp. B-3-4.

[19] Dr. Van Lierop testified that Commission regulation prevents the undue exercise of market power when the utility is the monopoly provider of specific services. Tr. 1/43-44. Cost-based rates for unbundled storage will prevent the exercise of market power by SoCalGas with respect to the unbundled storage program.

The Commission should be very concerned, however, about SoCalGas and SDG&E's statement that a 50 percent shareholder incentive is required in order to ensure "aggressive and innovative" marketing of unbundled storage. SoCalGas/SDG&E witness Steven Watson acknowledged that SoCalGas has a responsibility to maximize its revenues from the sale of unbundled storage regardless of the level of the incentive that SoCalGas' shareholders receive from the unbundled storage revenues. Tr. 2/231. Yet Mr. Watson suggested that SoCalGas will not assign its "best and brightest" employees to the unbundled storage program unless utility shareholders receive an incentive with respect to unbundled storage revenues. See Tr. 2/232.

If SoCalGas has an obligation to maximize unbundled storage revenues for the benefit of its customers, SoCalGas should not require an incentive payment in order to fulfill its obligation. Under cost-based rates, SoCalGas will earn a return on its investment in storage infrastructure. Tr. 2/222 (Watson). SoCalGas should not receive an additional incentive in order to encourage SoCalGas to maximize the use of these facilities.

Regardless of whether unbundled storage is priced on a cost-of-service basis or at market-based rates, all revenues from SoCalGas' sale of unbundled storage should be returned to SoCalGas' end-use customers. SoCalGas should enjoy balancing account treatment for its unbundled storage revenue requirement. The treatment of unbundled storage revenues should be the same as the treatment of SoCalGas' unbundled backbone transmission revenues. See Ex. 59 (Dyer) at p. 39.

G. The Commission Must Establish Policies and Standards for the System Operator

1. Shareholders Should Not Benefit from Hub Services or Receive Any Portion of Interruptible Access Charge Revenues

SoCalGas/SDG&E propose that 50 percent of the System Operator's Hub revenues should be retained by Sempra shareholders. See Ex. 31 (Schwecke) at pp. 3-4. SoCalGas/

SDG&E state that a 50/50 sharing of Hub revenues will "encourage SoCalGas and SDG&E to optimize and market the use of . . . Hub services." Brief at p. 23. In fact, the utilities state that "there will be significantly more hub revenues to share with ratepayers under a 50/50 mechanism than there would be under a 90/10 mechanism." Id. at p. 25.

Mr. Watson acknowledged, however, that if the Commission directs SoCalGas to maximize the use of underutilized storage for Hub services, the utilities have an obligation to do so, without regard to an "incentive." Tr. 2/231. No shareholder reward should be necessary in order for the System Operator to maximize Hub revenues for the benefit of SoCalGas/SDG&E's end-use customers.

SoCalGas/SDG&E similarly attempt to support a shareholder incentive for interruptible access charge revenues by threatening the Commission with what amounts to a work slowdown. The utilities state: "[T]o argue that SoCalGas and its employees would market and promote the use of interruptible access rights with the same level of vigor and innovation without a financial incentive is short-sighted." Brief at p. 51. The utilities state further that "little marketing or promotion of such [interruptible] capacity is likely without a financial incentive that justifies the efforts." Id.

The Commission should be very concerned about the message that the utilities are sending by these statements. Effectively, the utilities state that they require a "super-incentive" (beyond a return on equity) in order to perform the tasks that the Commission has otherwise directed them to provide. This should be a cause for concern. No shareholder incentive should be required for the System Operator to market Hub services or interruptible receipt point access rights.

The System Operator should have a fiduciary obligation to manage assets and provide services in a manner that maximizes benefits for the utilities' ratepayers. See Ex. 59 (Dyer) at pp. 30-31. The System Operator should not be a profit center for the utilities. The utilities should have an obligation to optimize revenues from Hub services and interruptible access charges in order to minimize the costs imposed upon ratepayers.

2. The Commission Should Clearly Delineate the Responsibilities of the System Operator

SoCalGas and SDG&E cavalierly dismiss Coral's proposals and concerns respecting the role and responsibilities of the System Operator. The Sempra utilities argue that many of Coral's recommendations with respect to the System Operator are "outside the scope of this proceeding . . . ." Brief at p. 33.

Contrary to SoCalGas and SDG&E's argument, the Assigned Commissioner's December 2006 Scoping Memo directed the utilities to submit supplemental testimony concerning the responsibilities of the System Operator. The Scoping Memo stated that "[t]he supplemental testimony shall explain the responsibilities of the Gas System Operator and the tasks to be performed in implementing the proposed transfer of system reliability functions." (Emphasis added.)[20]

During the hearing, SoCalGas/SDG&E witness Morrow testified concerning the breadth of the System Operator's responsibilities. See Tr. 3/364-74. Mr. Morrow testified that the System Operator's responsibilities are "broadly defined as those organizations that support the transmission and distribution and delivery of gas to our customers, . . . specifically excluding gas acquisition." Tr. 3/364. The System Operator's responsibilities extend to capacity products (i.e.

[20] A.06-08-026, "Assigned Commissioner's Ruling Providing Scoping Memo and Adopting Procedural Schedule," p. 5 (issued December 21, 2006).

firm and interruptible access rights), unbundled storage, Hub services, Gas Control, scheduling, and supervisory control and data acquisition. See Tr. 3/364-68 (Morrow); Ex. 21, 22.

An organization of this size, with wide-ranging responsibility for virtually all gas system activities (except the purchase and sale of core gas supply), should be subject to specific standards and protocols that are approved by the Commission. The utilities propose that the Hub services function and the system reliability function should be transferred to the System Operator, yet the utilities seek very little guidance from the Commission as to how the System Operator should perform these functions.

With respect to system reliability, the utilities make two proposals: first, that the System Operator should be allowed to buy and sell gas on a spot basis; and second, that the System Operator should be allowed to seek approval of other system reliability "tools" through an expedited advice letter process. See Ex. 30 (Schwecke) at p. 2. Regarding the proposed expedited advice letter process, SoCalGas and SDG&E's opening brief utterly fails to support their proposal, other than to say that this is the "appropriate vehicle" to consider system reliability tools. Brief at p. 33.[21]

Coral submits that the utilities missed an important opportunity in this proceeding to pursue Commission approval of specific "tools" by which the System Operator may provide system reliability. SoCalGas/SDG&E witness Rodger Schwecke identified a number of tools for which the System Operator may seek Commission approval in the future. See Ex. 29 at pp. 3-4; Ex. 30 at p. 2. Yet SoCalGas/SDG&E do not request Commission approval in this proceeding for even the types of tools to be used to provide system reliability. The utilities' failure to provide more specific information regarding the System Operator's "tools," and the utilities'

[21] The utilities state that an expedited approval process is needed so that the approval process is not "slow(ed) down." Id. at p. 34.

failure to seek Commission approval of specific tools, demonstrates a failure to meet the utilities' burden of proof. If the System Operator wishes to pursue specific tools for system reliability, Coral agrees with SCGC that SoCalGas/SDG&E should be required to file a formal application for Commission approval. See SCGC Brief at pp. 38-39.

Coral witness Dyer also expressed concern regarding the utilities' failure to address Commission oversight of the System Operator. See Ex. 59 (Dyer) at pp. 34-35. In response, SoCalGas/SDG&E state that "[t]he additional oversight provisions we have proposed for the System Operator's fulfillment of these new responsibilities represent a reasonable and appropriate enhancement of existing Commission oversight activities." Brief at p. 34.

Contrary to SoCalGas/SDG&E's representations, the utilities' testimony did not address "additional oversight provisions" for the System Operator. The utilities failed to provide standards of conduct for the System Operator and the utilities failed to provide a reporting structure or any means of accountability. Notwithstanding the utilities' failure to advance a proposal respecting standards of conduct for the System Operator, the Commission must address the matter in this case.

The System Operator should be required to submit periodic reports to the Commission's Energy Division, through the advice letter process, aggregating and summarizing the daily operational information that it has posted to the EBB. See Ex. 59 (Dyer) at p. 35. The System Operator also should be subject to penalties for failure to comply with Commission directives. Penalties imposed upon the System Operator should be borne by shareholders, not ratepayers.

3. The System Operator Must be Subject to the Same Rules and the Same Charges as Other Market Participants When it Engages in the Purchase and Sale of Gas, Transportation, Storage, and Receipt Point Access

Because it will occupy a unique position as administrator of the Sempra utilities' storage and transportation assets, the System Operator will have access to operational information that is not available to other market participants. The System Operator also will have access to individual shipper information. The System Operator should not be allowed to use its unique position to gain an advantage in the purchase or sale of natural gas, transportation capacity, storage or receipt point access rights.

Moreover, the System Operator must be subject to the same charges as all other market participants (e.g., firm or interruptible receipt point access charges) when it purchases or sells natural gas. SoCalGas/SDG&E did not address this issue in their opening brief, yet Mr. Schwecke testified that the System Operator should not be required to bear firm or interruptible access charges in order to ship gas from a receipt point to the citygate. Tr. 4/501. The Commission should not provide the System Operator with a competitive advantage when the System Operator is engaged in the purchase or sale of gas or capacity. The System Operator should be subject to the same charges as all other market participants.

IV.

CONCLUSION

The stated purpose of the settlement agreement is to mitigate SoCalGas' market power in southern California by providing increased transparency, separating SoCalGas' operational function from its procurement function, providing equal treatment of core and noncore customers with respect to transportation service, and imposing restrictions on the core procurement department's "optionality." In its opening brief, Edison stated that the settlement agreement is a "step in the right direction" in mitigating SoCalGas' market power. Brief at p. 6.

In reality, however, the settlement agreement moves the gas market backwards rather than forward with respect to mitigation of SoCalGas' market power. The structural proposals not only fail to achieve the stated purpose of the settlement agreement, but in many areas the structural proposals, if adopted, would actually undermine the stated objective, resulting in increased market power and increased flexibility for the Sempra utilities.

The settlement proposals, individually and collectively, would enhance SoCalGas' market power, unjustly enrich SoCalGas and SDG&E's shareholders, impose ineffectual restrictions on the core procurement department, and create the potential for the exercise of market power by the new System Operator. In addition, the structural proposals would adversely impact core procurement customers through the exclusion of hedged transactions from the GCIM and through the continued encouragement of index-priced gas purchases by the core procurement department.

The Commission should adopt structural changes to the SoCalGas/SDG&E system that mitigate SoCalGas' market power with respect to storage and transportation in southern California. Specifically, the Commission should adopt Coral's proposed Core Portfolio Diversity Program, approve Coral's proposed modifications to the gas purchase incentive mechanism, adopt cost-based rates for unbundled storage, and adopt reasonable restrictions on the exercise of market power by the System Operator.

Respectfully submitted,

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Date: July 20, 2007

CERTIFICATE OF SERVICE

I hereby certify that I have served, this day, a copy of the foregoing **REPLY BRIEF OF CORAL ENERGY RESOURCES, L.P.** on the Honorable Michael R. Peevey, Assigned Commissioner and the Honorable Thomas R. Pulsifer, Presiding Administrative Law Judge by electronic mail and Federal Express; and on all parties on the service list for A.06-08-026 by electronic mail only.

Executed on July 20, 2007, at San Diego, California.

/s/
Debra A. Casebier

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